

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Perata Analyst: John Pavalasky Bill Number: SB 1017  
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 23, 2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Taxation Of Trusts Created By California Residents

### SUMMARY

This bill would limit California's ability to tax the income of a trust created by a nonresident.

### PURPOSE OF THE BILL

According to the author's office, this bill is intended to relieve taxpayers from double taxation.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately and apply to taxable years beginning on or after January 1, 2001.

### POSITION

Pending.

### Summary of Suggested Amendments

Substantive amendments are necessary to resolve the implementation and policy considerations discussed in this analysis. Department personnel are available to help resolve these considerations as the bill moves through the legislative process.

### ANALYSIS

#### FEDERAL/STATE LAW

Under federal and state law, trusts are generally treated as separate taxpayers and, with some important qualifications, are taxed in the same way as individuals. Trust income is normally taxed to the trust itself, if retained by the trust, or to the beneficiary, if distributable (whether or not actually distributed). Thus, if the fiduciary passes on income to the beneficiary, the trust deducts the distributed income that then becomes taxable to the beneficiary. A special measure called "distributable net income" (DNI) is used to limit both the amount deducted by the trust as a distribution and the amount taxed to the beneficiary.

#### Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

#### Department Director

#### Date

Alan Hunter for GHG

05/10/01

If a person (grantor) creates several or "multiple" trusts, each trust is generally treated as a separate taxpayer. Several separate trusts may be created even though there is only one trust instrument and only one trustee.

If the grantor retains the power to revoke the trust (revocable trust) or a substantial reversionary interest, the grantor is treated as the owner of the property of the trust for income tax purposes. Such trusts are referred to as "grantor trusts."

### FEDERAL FOREIGN TRUST RULES

Under special rules relating to foreign trusts for federal purposes, a foreign trust is taxed on its income **as if it were a nonresident alien individual**. In addition, a U.S. beneficiary of a foreign trust is taxed on the foreign trust's foreign- and U.S.-source income at the time that it becomes distributable. Distributions to the U.S. beneficiary of accumulated trust income are subject to the "throwback" rules and a nondeductible interest charge for the deferral of tax is also imposed.

The "throwback" rules tax beneficiaries on distributions of income accumulated by the trust before the year of distribution, as though the income had been distributed to the beneficiary in each earlier year and included in the beneficiary's income in that earlier year.

The beneficiary is not required to file amended returns for the earlier year but, instead, attaches a schedule to the return showing the increase in tax in each earlier year that would have been owed had the distribution actually taken place in that earlier year. The aggregate amount of the increased taxes shown on this schedule, plus a special nondeductible interest charge for the deferral of the increased taxes, is added to the tax due on the return for the year the distribution is made.

Also for federal purposes, special rules apply if a U.S. grantor creates a foreign trust with a U.S. beneficiary. In that case, the income of the trust (including foreign source income) is taxed currently to the grantor as the owner of the trust. These rules also apply when:

- a foreign person transfers property to a foreign trust and later becomes a U.S. person, and
- a U.S. person who transfers property to a domestic trust that becomes a foreign trust during the U.S. person's life.

Thus, under these special federal rules, those foreign trusts are not subject to U.S. tax on income accumulated by the trusts.

### CALIFORNIA FOREIGN TRUST RULES

California has evolved a comprehensive system for the taxation of income patterned upon the federal tax structure, which treats a trust as a separate economic entity. However, California law specifies that federal rules relating to nonresident aliens do not apply, and has not adopted the special grantor trust rules relating to taxing currently the person who creates a foreign trust on the entire income of that trust.

California requires the trustee to pay, on behalf of the trust, taxes due on the taxable income of the trust. That income includes income that the trust accumulates or holds for future distribution to a beneficiary. Whether the trust is taxable on its entire taxable income or only on income from California sources depends on whether the fiduciary or beneficiary (other than a beneficiary whose interest in the trust is contingent) is a resident, regardless of the residence of the grantor. Special rules pro-rate the taxable income from sources outside California when a trust has multiple trustees or beneficiaries (or both multiple trustees and multiple beneficiaries) and some of them are nonresidents of California.

The constitutionality of California taxing the trust on its entire taxable income (even when the corpus of the trust is located in another state) based upon the residence of either the beneficiary or the trustee was upheld in McCulloch v. Franchise Tax Board (1964) 61 Cal.2d 186 [390 P.2d 412, 37 Cal.Rptr. 636] app. dism. per *curiam*, (1964) 379 U.S. 133, [85 S.Ct. 278, 13 L.Ed.2d 333], reh'g. den. (1965) 379 U.S. 984 [85 S.Ct. 644, 13 L.Ed.2d 578]. That case states that the jurisdiction of California to tax the entire taxable income of the trust is acquired (has nexus) by reason of the protection afforded to the trust, trustee, or beneficiary by the state of California.

That case also articulated the rule (which was later codified) for computing the tax on the beneficiary, as a transferee liability, when the trust failed to pay the taxes due for the year the income was accumulated and then distributed that income in a later year to the beneficiary. For income accumulated before 1963, the beneficiary is assessed a transferee liability for the aggregate amount of tax that would have been owed by the trust in each year the income was earned. That aggregate amount of taxes the trust would have owed is added to the tax due on the return of the beneficiary for the year the distribution is made. For income accumulated by the trust after 1962, California uses the federal "throwback" rules but the averaging period is no greater than the distribution year plus the five years prior to the year of distribution.

Thus, under current law, whether the trust is taxable on its entire taxable income or only on income from California sources depends on whether the fiduciary or beneficiary (other than a beneficiary whose interest in the trust is contingent) is a resident, regardless of the residence of the grantor.

### THIS BILL

This bill would further restrict California taxation of a trust's entire taxable income to instances where the trust was created by a California resident. The provision appears to apply to any trust regardless of whether the trust, when it was created, was revocable or irrevocable.

### IMPLEMENTATION CONSIDERATIONS

It is unclear when California residence of the grantor provides the basis for taxation of a trust. The bill could be interpreted to limit taxation to those trusts that were created by a resident at the time the trust was created or to those trusts that were created by a resident at the time of taxation of trust income.

This bill does not provide the method to be used to tax the income of a trust when a nonresident of California created the trust. Thus, for trusts whose grantor was never a California resident, it could be argued that California would be allowed to tax the trust only on income from California sources even when the trustee and beneficiary were California residents. Without clear rules for these complex calculations, disputes may arise between taxpayers and the department.

This bill also does not provide rules regarding:

- the change in the taxation of a trust (from a source basis to an entire income basis) when the person who created the trust moves into or out of California. That is, does the taxability of the trust created by a California resident change when the person who created the trust becomes a nonresident (or vice versa) of California after creating the trust?
- the taxation of a California beneficiary receiving a distribution of accumulated income from the trust. That is, what rules does the California beneficiary use to determine the amount of tax to pay in the year of distribution whether the trust has paid California tax or not upon the income being distributed?

## LEGISLATIVE HISTORY

AB 36 (Hannigan, Ch. 488, Stats. 1983) adopted federal law by reference while retaining specific rules relating to taxability of a trust with a resident fiduciary or beneficiary.

## OTHER STATES' INFORMATION

The following states were examined due to similarities to California of those states' population and business activity.

*Florida* imposes an intangible personal property tax on a trust with a Florida situs when:

- all trustees are residents of Florida;
- there are three or more trustees sharing equally in the ownership, management, or control of the trust's intangible property, and the majority of the trustees are residents of Florida; or
- trustees consist of both residents and nonresidents and management or control of the trust is with a resident trustee.

If the trust is administered and managed completely out of state, it does not have a Florida taxable situs and is not subject to the intangible personal property tax.

*Illinois, Michigan, Minnesota, and New York* tax the following trusts in the same manner as an individual resident of that state (i.e., on the entire taxable income):

- a trust created by a will of a decedent who at his or her death was domiciled in that state; or
- a trust that was an irrevocable trust, whose grantor was domiciled in that state at the time the trust became irrevocable. For purposes of this definition, a trust is irrevocable to the extent that the grantor is not treated as the owner of the trust under federal law.

All other trusts are taxed in the same manner as an individual nonresident of that state (i.e., on the income having a source in that state).

*Massachusetts* taxes trust income only at the fiduciary level and the beneficiaries are not taxed when the income is distributed. The trust is taxed based upon the type of income and whether the fiduciary or beneficiary is a resident of the state. A trust with a resident fiduciary is taxed on the entire taxable income of the trust if the beneficiaries are residents.

A trust with a resident fiduciary is taxed only on the taxable income having a source in the state if the beneficiaries are nonresidents. A trust with a nonresident fiduciary is taxed only on the taxable income having a source in the state if the beneficiaries are residents and those beneficiaries are not taxed when the income is distributed. Massachusetts does not tax the trust with a nonresident fiduciary on income from outside the state that is accumulated on behalf of beneficiaries that are nonresidents in the year of accumulation.

## FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

## ECONOMIC IMPACT

### Tax Revenue Estimate

Based on available information for trusts filing for the 1998 tax year, the following estimates provide order of magnitude revenue losses for the initial three years.

Estimated Revenue Impact of SB 1017		
As Introduced 2/23/01 [\$ In Millions]		
2001-02	2002-03	2003-04
-\$35	-\$120	-\$180

The bill would be effective with taxable years beginning on or after January 1, 2001, with enactment assumed after June 30, 2001.

### Tax Revenue Discussion

For the 1998 tax year, total income tax paid by taxable trusts was approximately \$360 million. Estimates above assume that the potential amount of revenue loss from restricting the taxation of trusts (existing and newly-formed) to trusts created by grantors who are residents of California would comprise 10% for the first year, growing to one-third by the second year, and to one-half by the third year.

## ARGUMENTS/POLICY CONCERNS

Under this bill, it could be argued that a trust created by will (testamentary trust) where the decedent is a California resident at the date of death, but has no California beneficiaries or trustees, would be taxable by California on its entire income even though the trust did not exist prior to the date of death, has no resident beneficiaries, and is administered completely outside of California. In this situation, there may be a legitimate issue of whether California has the requisite constitutional nexus to tax the trust simply because the decedent whose will created the trust was a California resident at date of death.

Under this bill, the California tax on income accumulated by a trust with a nonresident grantor that has California beneficiaries will be deferred until it is distributed, rather than being paid each year that the income is accumulated. Should California conform to the federal rule, applicable to foreign trust accumulations, that imposes a nondeductible interest charge on a beneficiary receiving the distribution as a price for the state permitting a current deferral of that tax?

#### **LEGISLATIVE STAFF CONTACT**

John Pavalasky  
Franchise Tax Board  
845-4335

Brian Putler  
Franchise Tax Board  
845-6333